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EXPOSURE DRAFT

OMNIBUS PROPOSAL OF PROFESSIONAL ETHICS DIVISION INTERPRETATIONS AND RULINGS

PROPOSED INTERPRETATION UNDER RULE 101: Extended Audit Services
☐ PROPOSED RULINGS UNDER RULE 101: Member Providing Attest Report on Internal Controls ☐ Member Providing Operational Auditing Services ☐ Frequency of Performance of Extended Audit Procedures ☐ PROPOSED DELETION OF RULING NO. 97 UNDER RULE 101: Performance of Certain Extended Audit Services ☐ PROPOSED REVISION OF RULING NO. 17 UNDER RULE 101: Financial Interests in Certain Organizations ☐ PROPOSED RULING UNDER RULE 501 AND RULE 301: Member Removing Files or Workpapers From an Accounting Firm ☐ PROPOSED RULING UNDER RULE 503 AND RULE 302: Member Operating a Separate Business That Receives Commissions or Contingent Fees

FEBRUARY 28, 1996

Prepared by the AICPA Professional Ethics Executive Committee for comments from persons interested in independence, behavioral, and technical standards matters

**Comments should be received by April 28, 1996, and addressed to
Herbert A. Finkston, Director, Professional Ethics Division,
AICPA, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881.**

*This exposure draft has been sent to persons
who have requested copies.*

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Any individual or organization may obtain one copy of this document without charge until the end of the comment period by writing to the AICPA Order Department, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881.

February 28, 1996

This exposure draft contains eight proposals for review and comment by the Institute's membership and other interested parties regarding pronouncements to be adopted by the Professional Ethics Executive Committee. The text of and an explanatory preface to each pronouncement are included in this exposure draft.

A summary does not accompany this exposure draft because of the diversity of material included. Instead, the type of information a summary would contain is included in the "Explanation" sections.

After the exposure period is concluded and the comments have been evaluated by the Professional Ethics Executive Committee, the committee may decide to publish one or more of the proposed pronouncements. Once published, the pronouncements become effective on the last day of the month in which they are published in the *Journal of Accountancy*, except as otherwise stated in the pronouncements.

Your comments are an important part of the standard-setting process. Please take this opportunity to comment. Responses should be made under the appropriate heading on the enclosed response form. They must be received at the AICPA by April 28, 1996. All written replies to this exposure draft will become part of the public record of the AICPA and will be available for inspection at the office of the AICPA after May 31, 1996, for a period of one year.

Please send comments to Herbert A. Finkston, Director, AICPA Professional Ethics Division, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881.

Sincerely,



L. Glenn Perry
Chair
AICPA Professional Ethics
Executive Committee



Herbert A. Finkston
Director
AICPA Professional
Ethics Division

[*Explanation*]

The AICPA *Code of Professional Conduct* permits the performance by members and their firms of nonattest services for attest clients without impairing independence on condition that the member or his or her firm does not act or appear to act in any capacity equivalent to a member of client management or of an employee. The Professional Ethics Executive Committee believes this proposed interpretation and these proposed rulings establish clear guidelines for the planning and performance of extended audit services for attest clients, and that compliance with these proposed pronouncements will maintain the independence of the member and his or her firm. The committee also proposes the deletion of ethics ruling no. 97 [ET section 191.194–.195] upon adoption of the proposed interpretation and rulings.

PROPOSED INTERPRETATION UNDER RULE 101

[*Text of Proposed Interpretation Under Rule 101*]

Extended Audit Services

A member or a member's firm (the member) may be asked by a client, for which the member performs a professional service requiring independence, to perform extended audit services. These services may include assistance in the performance of the client's internal audit activities and/or an extension of the member's audit service beyond the requirements of generally accepted auditing standards (hereinafter referred to as "extended audit services").

A member's performance of extended audit services would not be considered to impair independence with respect to a client for which the member also performs a service requiring independence, provided that the member or his or her firm does not act or does not appear to act in a capacity equivalent to a member of client management or as an employee.

The responsibilities of the client, including its board of directors, audit committee, and management, and the responsibilities of the member, as described below, should be understood by both the member and the client. It is preferable that this understanding be documented in an engagement letter that indicates that the member may not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of an employee.

A member should be satisfied that the client understands its responsibility for establishing and maintaining internal control¹ and directing the internal audit function, if any. As part of its responsibility to establish and maintain internal control, management monitors internal control to assess the quality of its performance over time. Monitoring can be accomplished through ongoing activities, separate evaluations, or a combination of both.

Ongoing monitoring activities are the procedures designed to assess the quality of internal control performance over time and that are built into the normal recurring activities of an entity and include regular management and supervisory activities, comparisons, reconciliations, and other routine actions. Separate

¹ In December 1995, the AICPA's Auditing Standards Board issued Statement on Auditing Standards No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*. The pronouncement describes the objectives and components of internal control.

evaluations focus on the continued effectiveness of a client's internal control. A member's independence would not be impaired by the performance of separate evaluations of the effectiveness of a client's internal control, including separate evaluations of the client's ongoing monitoring activities.

The member should understand that, with respect to the internal audit function, the client is responsible for—

- Designating a competent individual or individuals, preferably within senior management, to be responsible for the internal audit function.
- Determining the scope, risk, and frequency of internal audit activities, including those to be performed by the member providing extended audit services.
- Evaluating the findings and results arising from the internal audit activities, including those performed by the member providing extended audit services.
- Evaluating the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining reports from the member.

The member should be satisfied that the board of directors and/or audit committee is informed of roles and responsibilities of both client management and the member with respect to the engagement to provide extended audit services as a basis for the board of directors and/or audit committee to establish guidelines for both management and the member to follow in carrying out these responsibilities and monitoring how well the respective responsibilities have been met.

The member should be responsible for performing the audit procedures in accordance with the terms of the engagement and reporting thereon. The day-to-day performance of the audit procedures should be directed, reviewed, and supervised by the member. The report should include information that allows the individual responsible for the internal audit function to evaluate the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures. This report may include recommendations for improvements in systems, processes, and procedures. The member may assist management in performing preliminary audit risk assessments, preparing audit plans, and recommending audit priorities. However, the member should not undertake any responsibilities that are required, as described above, to be performed by the individual responsible for the internal audit function.

Performing procedures that are generally of the type considered to be extensions of the member's audit scope applied in the audit of the client's financial statements, such as confirming of accounts receivable and analyzing fluctuations in account balances, would not impair the independence of the member or the member's firm even if the extent of such testing exceeds that required by generally accepted auditing standards.

The following are examples of activities that, if performed as part of an extended audit service, would be considered to impair a member's independence:

- Performing ongoing monitoring activities or control activities (for example, reviewing loan originations as part of the client's approval process or reviewing customer credit information as part of the customer's sales authorization process) that affect the execution of transactions or ensure that

transactions are properly executed, accounted for, or both, and performing routine activities in connection with the client's operating or production processes that are equivalent to those of an ongoing compliance or quality control function

- Determining which, if any, recommendations for improving the internal control system should be implemented
- Reporting to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function
- Authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the client
- Preparing source documents on transactions
- Having custody of assets
- Approving or being responsible for the overall internal audit work plan including the determination of the internal audit risk and scope, project priorities, and frequency of performance of audit procedures
- Being connected with the client in any capacity equivalent to a member of client management or as an employee (for example, being listed as an employee in client directories or other client publications, permitting himself or herself to be referred to by title or description as supervising or being in charge of the client's internal audit function, or using the client's letterhead or internal correspondence forms in communications)

PROPOSED RULINGS UNDER RULE 101

[Text of Proposed Rulings Under Rule 101]

Member Providing Attest Report on Internal Controls

Question — If a member or a member's firm (member) provides extended audit services for a client, in compliance with Interpretation 101-XX [ET section 101.XX], would the member be considered independent in the performance of an attestation engagement to report on the client's assertion regarding the effectiveness of its internal control over financial reporting?

Answer — Independence would not be impaired with respect to the issuance of such a report if all the following conditions are met:

1. The member's activities have been limited in a manner consistent with Interpretation 101-XX [ET section 101.XX].
2. Management has assumed responsibility to establish and maintain internal control.
3. As a basis for its assertion, management has (a) evaluated the results of its ongoing monitoring procedures built into the normal recurring activities of the entity (including regular management and supervisory activities) and (b) evaluated the findings and results of the member's work and other separate evaluations of controls, if any.

Member Providing Operational Auditing Services

Question — As part of an extended audit engagement, the member or the member's firm may be asked to review certain of the client's business processes, as selected by the client, for how well they function, their efficiency, or their effectiveness. For example, a member may be asked to assess whether performance is in compliance with management's policies and procedures, to identify opportunities for improvement, and to develop recommendations for improvement or further action for management consideration and decision making. Would the member's independence be considered to be impaired in performing such a service?

Answer — The member's independence would not be considered to be impaired provided that during the course of the review the member does not act or appear to act in a capacity equivalent to that of a member of client management or of an employee. The decision as to whether any of the member's recommendations will be implemented must rest entirely with management.

Frequency of Performance of Extended Audit Procedures

Question — In providing extended audit services, would the frequency with which a member performs an audit procedure impair the member's independence?

Answer — The independence of the member or the member's firm would not be considered to be impaired provided that the member's activities have been limited in a manner consistent with Interpretation 101-XX [ET section 101.XX] and the procedures performed constituted separate evaluations of the effectiveness of the ongoing control and monitoring activities/procedures that are built into the client's normal recurring activities.

PROPOSED DELETION OF RULING NO. 97 UNDER RULE 101

[Text of Ruling Proposed for Deletion]

Performance of Certain Extended Audit Services

Question—A client is considering engaging a member to assist with the performance of its internal audit activities or extend the member's audit services when the client does not maintain an internal audit function. The activities that the member would be engaged to perform could include, among other things, the following: (1) testing the system of internal controls, confirming accounts receivable, and analyzing fluctuations of income and expense accounts; (2) reviewing loan originations or similar activities as part of the client's approval process or internal control system; and (3) reviewing the client's loan origination or other business processes for their functioning, efficiency or effectiveness and providing recommendations to management. Would independence be considered to be impaired if the member performs any of these services?

Answer—The performance of activities such as those described in (1) above would not impair independence regardless of whether the member assists in the performance or performs all such activities for the client. The activities described in (1) above are generally of the type considered to be extensions of audit procedures to be performed in conducting the annual audit, even though the extent of testing may exceed that required by generally accepted auditing standards. The performance of the activities in (2) above would impair independence because the member would be performing a management function. The activities described in (3) above, although not generally considered necessary for conducting the annual audit, are services that would not impair independence as long as the member does not perform management functions or make management decisions.

PROPOSED REVISION OF RULING NO. 17 UNDER RULE 101

[*Explanation*]

The Professional Ethics Executive Committee proposes to revise current ethics ruling no. 17 [ET section 191.033–.034] to indicate that a debt or equity interest held by a member in an organization such as a country club constitutes a loan to or a direct financial interest in the organization, respectively, that impairs a member's independence. Membership in a club, absent an equity or debt interest, would not impair independence.

[*Text of Proposed Revision to Ruling No. 17*]*

Member of Social Club Financial Interests in Certain Organizations

Question — A member belongs to a social club (for example, country club, tennis club) **an organization (such as a country club or health club)** in which membership requirements involve the acquisition of a **pro rata share of owning** equity or debt securities. Would the independence of the **member or** member's firm be considered to be impaired with respect to the **social club organization**?

Answer — ~~As long as membership in a club is essentially a social matter, i~~Independence of the **member or** member's firm would ~~not~~ be considered to be impaired because such equity or debt ~~ownership interest~~ **interest** is ~~not~~ considered to be **either a direct financial interest in, or a loan to, a client, respectively, which is prohibited under within the meaning of rule 101 [ET section 101.01].** However, ~~the member should not serve on the club's governing board or take part in its management.~~

* Strikethrough denotes proposed deletions to current text. Boldface denotes proposed new language.

PROPOSED RULING UNDER RULE 501 AND RULE 301

[*Explanation*]

The Professional Ethics Executive Committee proposes the following ethics ruling to provide guidance to Institute members who have terminated or are terminating their relationship with an accounting firm. The proposed ruling prohibits a member from removing originals or copies of client files or proprietary information of the firm without permission and reminds the member of his or her obligation under rule 301 to obtain client permission prior to disclosing any confidential information to a new firm.

[*Text of Proposed Ruling Under Rule 501 and Rule 301*]

Member Removing Files or Workpapers From an Accounting Firm

Question—If a member terminates his or her relationship with a firm, may he or she take original or copies of client files or proprietary information of the firm without the firm's permission?

Answer—No, except where permitted by contractual arrangement. If, upon leaving the firm, the member takes any of the firm's files or proprietary information without permission, the member would be committing an act discreditable to the profession in violation of rule 501 [ET section 501.01].

If the member provides original or copies of client files, records or workpapers to another firm without the prior specific consent of each client, the member would also be in violation of Rule 301, *Confidential Client Information* [ET section 301.01].

PROPOSED RULING UNDER RULE 503 AND RULE 302

[*Explanation*]

The Professional Ethics Executive Committee proposes the following ethics ruling to provide guidance to Institute members who are considering operating a separate business that will derive income from commission or contingent fee-based services. The committee proposes that the receipt of commissions or contingent fees by the separate business constitutes the receipt of commissions or contingent fees by the member if the member can exercise significant influence over the separate business.

[*Text of Proposed Ruling Under Rule 503 and Rule 302*]

Member Operating a Separate Business That Receives Commissions or Contingent Fees

Question—A member in public practice is also an owner, employee, or contractor of a separate entity that provides financial services (e.g., mortgage, real estate or insurance brokerage, sale of investments, or investment advice). The entity receives commissions and/or contingent fees in connection with those services. Clients of the member or his or her firm use the services of the separate entity. Do rules 503 (*Commissions and Referral Fees*) and 302 (*Contingent Fees*) apply?

Answer—Receipt of commissions or contingent fees by the separate entity constitutes receipt of commissions or contingent fees by the member if the member can exercise significant influence over the entity, as defined in Interpretation 101–9 [ET section 101.11].